DEPARTMENT OF STATE REVENUE

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Sales and Use Tax
For Tax Periods: 1993 Through 1995

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ISSUES

1. Sales and Use Tax: Manufacturing Exemption

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8; Mechanic's Laundry and Supply, Inc. v. Department of State Revenue, 650 N.E.2d 1228 (1995); Rotation Products Corp. v. Department of State Revenue, Indiana Tax Court, No. 49TT10-9508-TA-00081, January 30, 1998.

STATEMENT OF FACTS

Taxpayer is an out of state corporation which recycles and treats environmentally sensitive by products and waste streams. It also manufactures and markets specialty chemicals to buyers in the oil and gas, environmental, and municipal markets. From 1990-1993, Taxpayer's principal Indiana business activity was the construction and operation of a "de-oiling" facility at an unrelated steel mill site pursuant to a "Processing Service Provider Agreement." The steel production process creates a waste byproduct of oily and unusable mill scale. Taxpayer's facility used a combination of temperature, surface chemistry modification and mechanical energy to scrub the oil from the fine solids of the mill scale. Taxpayer's process resulted in iron ore that could be used as an integral part of the steel manufactured for sale by the steel mill and fuel oil for further use by the steel mill in the steel making process. The Department issued an assessment of additional Gross Retail Tax due on the tangible personal property used in Taxpayer's processing of oily mill scale at their Indiana facility. Taxpayer filed a timely protest to the tax assessment. Further facts will be provided as necessary.

SALES AND USE TAX : MANUFACTURING EXEMPTION

DISCUSSION

Generally, all purchases of tangible personal property are subject to the gross retail or sales and use tax.

However, IC 6-2.5-5-3 and 45 IAC 2.2-5-8 provide that manufacturing machinery, tools and equipment are exempt from sales and use tax if the property is acquired " for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining or finishing of other tangible personal property." The Taxpayer argues that it was in the business of producing usable iron ore and fuel oil from the steel mill's oily mill scale waste product. This would qualify Taxpayer's purchases as exempt from the sales and use tax. The Auditor argues that Taxpayer provided a service to its customer. Machinery purchased to provide a service would not qualify for the manufacturing exemption.

The taxpayer relies on Rotation Products Corp. v. Department of State Revenue, Indiana Tax Court, No. 49T10-9508-TA-00081, January 30,1998. In that case, Rotation Product Corp. successfully argued that it took raw materials in the form of unusable roller bearings and created an entirely new product, i.e., the remanufactured roller bearings.

The Court found that this was a production process and not a service. To come to this conclusion, the Court instituted a four-prong test to distinguish a production process from a service. First, a production process must be complex and substantial and produce a different end product. Secondly, the property must become more valuable in the process. Thirdly, the end product of the process must compare favorably with newly manufactured articles of its kind. Finally, the process must not be part of the normal life cycle of the original product.

Taxpayer's process performed a substantial and complex operation on the oily mill scale. There are several phases in the operation. The basic process consisted of processing the oily mill scale in a three-stage countercurrent scrubbing operation. In the operation, a liquid stream of water with alkaline salts and surface chemistry modifiers was recirculated countercurrent to the direction of the movement of the solids. Each stage of the scrubbing operation consisted of a reaction tank and a solids/liquid separation step. Following the three stage scrubbing process, the mill scale was dewatered on a horizontal dewatering belt, and conveyed to the finished product file. The residual liquid from the process, containing oil and very fine solids, flowed to a clarifier for initial solids and oil separation, followed by a process for removal of the ultrafine solids and any remaining oil. The remaining solution was recirculated back through the process until there was no scale. Additional facilities were installed to process even finer solid particles with higher oil levels yielding clean oil for use as a fuel by the steel mill. This process is substantial and complex. It changes both the physical and chemical properties of the mill scale. The end product was substantially different than the initial product. Taxpayer's process, therefore, meets the first test of being a production process.

Secondly, the Court requires that one compare the value of a product before and after the process to determine if a production process exists. In the instant case, the Taxpayer took waste material that the steel mill had previously just stockpiled and changed it into usable iron ore and fuel oil. Prior to this process, the steel mill merely dumped the mill scale into storage pits and into Lake Michigan. The steel mill had created a veritable mountain of mill scale in Lake Michigan. Clearly the mill scale had no value prior to Taxpayer's processing of it. At the end of the production process, however, Taxpayer provided the steel mill with iron ore and fuel oil that it used in its facility. Since it was usable in the steel mill, the end product was much more valuable than the original mill scale that was merely stockpiled in waste heaps. Taxpayer's process also meets the second test of being a production process.

The Court's third test had to do with comparing the product at the end of the process with other original or newly manufactured articles of like kind. In this situation the iron ore existing at the end of the Taxpayer's process is actually superior in that the content of its ore contains more iron than that the steel mill received from the typical mining processes. The mined ore generally was about 65-67% iron. The ore at the end of the Taxpayer's process was about 75-76% iron. The product at the end of Taxpayer's process clearly compares very favorably with original product iron ore. Taxpayer's process also meets the third test of being a production process as opposed to a service.

Finally, the Court considers whether the article at the end of the process is part of the expected life cycle of the original article produced. The Court drew this test from its finding in Mechanic's Laundry & Supply, Inc. v. Department of State Revenue, 650 N.E.2d at 1230. In that case Mechanic's Laundry washed shirts for customers. People purchase shirts with the expectation that they will be washed often during their normal life cycle. The laundering of the shirts was, then, a lengthening of the normal and expected life cycle or a service. In this case the normal life cycle of the mill scale was that it would sit forever in a waste heap. There was no expectation that the oily mill scale would have further usefulness. Taxpayer's process thus created a new product, it did not merely lengthen the expected life span of the original material, the oily mill scale. Therefore, the taxpayer's process meets the court's final test for being a product rather than a service.

Application of this four- pronged test to Taxpayer's production of iron ore and fuel oil from the oily mill scale indicates that the Taxpayer is actually engaged in the production of a new item of tangible personal property. Even though Taxpayer's contract is called a service contract, the taxpayer is actually engaged in the production of tangible personal property. Therefore, Taxpayer is entitled to the manufacturing exemptions from the gross retail tax.

FINDING

The taxpayer's protest is sustained.